

VENTURE CAPITAL INVESTMENT: STATUS AND TRENDS

BY DANA M. WARREN*

I. INTRODUCTION

This article looks at the status of macro trends in venture capital investing in light of the Great Recession and then examines whether those trends have had an impact on the transaction terms presented to entrepreneurs by venture capital investors.

II. PRELIMINARY QUESTION:

WHY LOOK AT VENTURE CAPITAL INVESTMENT?

The 2011 Symposium was entitled “The Big Squeeze: Small Business Financing During the Great Recession” and the symposium program featured a quote from Federal Reserve Chairman Ben Bernanke that read, in part: “Small businesses are central to creating jobs in our economy.”¹ Evidence suggests, however, that in the context of entrepreneurial activity (that is, the formation and operation of new business enterprises) most small businesses are not meaningful job creators.

Scott A. Shane, A. Malachi Mixon III Professor of Entrepreneurial Studies at Case Western Reserve University, examined entrepreneurship data in order to test the validity of common knowledge on the subject and assembled a fascinating array of information.² Professor Shane notes that while approximately two million new businesses are started in the United States each year, approximately seventy-five percent of those

* Patrick J. McDonough Director of the Business, Loyola Law School. It was a privilege to participate in the 2011 Symposium and I thank the board and staff of the Journal for the invitation and their hospitality during my stay in Columbus. I also want to thank my colleague Therese Maynard for her thoughts and insights on my presentation, and my wife, Linnea Warren, for her work on the graphs and charts as well as for her endless support and help.

¹ Ben S. Bernanke, Chairman, Fed. Res., Addressing the Financing Needs of Small Businesses, Speech at the Federal Reserve Meeting Series (July 12, 2010), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20100712a.htm>.

² See SCOTT A. SHANE, THE ILLUSIONS OF ENTREPRENEURSHIP: THE COSTLY MYTHS THAT ENTREPRENEURS, INVESTORS, AND POLICY MAKERS LIVE BY 3 (2008).

entrepreneurial efforts are self-employed people with no other employees.³ Of the approximately twenty-five percent of new businesses that the Small Business Administration refers to as “employer firms” started from 1989 through 2003 (which includes the spectacular period of growth reflected in the tech bubble of the ‘90s), only ten percent (approximately 50,000 businesses) had five or more employees.⁴ This is not simply the result of the high failure rate of new businesses. The fact is that fewer than one in five entrepreneurs even begin a business with a desire to grow it beyond one employee.⁵ In short, an overwhelming percentage of new businesses, and hence small businesses, do very little job creation.

Venture capital is relevant to job creation because early stage venture investment is focused exclusively on that tiny portion of small and new businesses that are formed with the intention of rapid growth. A fast-growing company quickly becomes an “employer firm” at the far end of the scale as it creates jobs to support its presumed large business opportunity. In 2008, companies that had received venture capital financing employed 12.1 million people, representing eleven percent of the private sector workforce.⁶ With the self-employed representing about 1.5 million of the approximately two million new businesses formed each year, and with venture capital investing in only 27,000+ companies cumulatively from 1970 to 2008,⁷ it should be apparent that the source of job creation is heavily skewed towards a very slender slice of new and small businesses.

In light of the manifest differences in the job creation nature of new businesses, public policy that is focused on small business or entrepreneurship generally as an engine for job growth is woefully misdirected. Instead, it is appropriate as a policy matter to direct attention to that minute portion of entrepreneurs who are building businesses that match the profile that venture capital investors seek because that is where the jobs are formed.

More specifically, at the Symposium we heard from a number of speakers that maintaining the current marginal ordinary income tax rates for

³ *Id.* at 11, 162.

⁴ *Id.* at 65.

⁵ *Id.* at 66.

⁶ NAT’L VENTURE CAPITAL ASS’N, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY (5th ed. 2009), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=482&Itemid=93.

⁷ See *id.*; SHANE, *supra* note 2, at 162; PricewaterhouseCoopers & Nat’l Venture Capital Ass’n, *MoneyTree Report*, PRICEWATERHOUSECOOPERS, <https://www.pwcmoneytree.com/MTPublic/ns/index.jsp> (last visited Oct. 24, 2011). MoneyTree Report is a product of collaboration between PricewaterhouseCoopers and the National Venture Capital Association based upon data from Thomson Reuters.

the highest tax brackets is an important priority for small business people. Consistent with the earlier quote from Chairman Bernanke,⁸ this position was supported with the argument that lower tax rates are key to allowing small business to continue to create jobs. Regardless of the merits of low tax rates, the data does not support job creation as a justification for this policy position.

Setting aside all the self-employment new businesses, consider an “employer firm” such as a new dry cleaning business. Assuming the owner of the dry cleaning shop is doing well enough to be taxed at the highest marginal rate, does lowering her tax rate cause her to hire another counter attendant? No, it simply puts more money in her pocket. It might well give her the resources to invest in a more sophisticated automation system that will pay for itself by eliminating a current employee, but a lower maximum marginal tax rate will not cause the owner to employ more people than the level of business operations requires. Further, it will not increase the level of the business’s operations.

New employees are hired because the demand for the business’s goods or services requires more personnel to create or provide those goods or services. It is axiomatic that venture capital investment is largely based on an anticipation of a big market for the goods or services a company is formed to provide. You have a big market when there are a lot of people spending large sums of money on weak or inadequate solutions to a problem that you solve effectively for the same or fewer dollars. When venture capitalists talk about large markets what they mean is that there will be huge demand for the product or service once it becomes available. Venture capital financed companies create jobs in anticipation of, and to serve, that demand. Tax policy that does not foster demand does not create jobs. Lowering (or maintaining low) maximum marginal tax rates does not foster demand because the portion of the population affected is too small for the extra disposable income to have an impact on the economy.

Alternatively, another tax policy change that is getting attention is the taxation applicable to venture capitalists’ “carry.” Without getting into too much detail, venture capital professionals typically operate as the general partner of a limited partnership investment fund. They are compensated through a management fee (ordinary income) and an allocation of the investment gains (usually capital gains) from the fund they manage, the latter based on the percentage of capital they invested in the fund. But, once all the invested capital has been returned to the limited partner investors (that is, the fund becomes profitable on an overall basis), the return allocation for the venture capitalists goes up to twenty percent of all returns, regardless of the portion of the capital they contributed to the fund. This step-up for good investment results is often called the “carry.” Since most

⁸ See Bernanke, *supra* note 1.

venture capital fund gains come from capital appreciation in the stock of the fund's portfolio, companies and limited partnerships are pass-through tax entities. Venture capitalists typically pay capital gain rates on the extra value received because of the carry, despite the fact that it is a compensation bonus for having invested the fund's money well, and higher ordinary income tax rates typically apply to compensation.

Similar carry structures are used by private equity funds (which usually specialize in acquisitions of businesses—payment goes to an existing owner and layoffs often follow—rather than investments—payment goes into the company to allow it to grow) and to hedge funds, which do all sorts of financial manipulations, often with large amounts of borrowed money. While the carry in venture capital funds has received some attention from tax analysts,⁹ it probably is the huge profits paid out to some hedge fund managers that gave this issue political traction. Venture capitalists may find themselves grouped with the private equity and hedge fund managers in some broadly applied tax reform to correct this perceived under-taxation. Regardless of the merits of this change in tax policy, it makes venture capital funds (the only one of the three fund types that actually invests in job-creating businesses) more expensive to operate and therefore less attractive as an investment opportunity for the pension funds and other institutional investors that provide the money to the venture capitalists. The end result could be less money would be invested in venture capital funds, which means less money would be available for that small segment of new companies that create jobs, which means fewer jobs would be created.

Thus, in the face of the Great Recession and the need for jobs to give people income so they can demand goods and services, and thereby create more jobs, venture capital plays a key role that needs to be understood so that the consequences of tax and other public policy decisions are better appreciated. Without advocating a position on either of the tax issues offered as examples, an examination of the realities of entrepreneurship and small business, and the role of venture capital investment, should lead to a better understanding of the consequences of these sorts of policy choices.

III. MACRO TRENDS IN VENTURE CAPITAL INVESTMENT.

Utilizing the MoneyTree Reports from PricewaterhouseCoopers and the National Venture Capital Association based on data from Thompson Reuters, our first objective is to look at the impact of the Great Recession on venture capital investment generally.¹⁰ The following charts address and

⁹ See, e.g., Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008).

¹⁰ See PricewaterhouseCoopers & Nat'l Venture Capital Ass'n, *MoneyTree Report: Q4 2010/Full-Year 2010*, PRICEWATERHOUSECOOPERS (2011), https://www.pwc.moneytree.com/MTPublic/ns/moneytree/filesource/exhibits/MoneyTree_Q42010_

allow us to discuss the implications of several important metrics in monitoring venture capital so that we can better understand the current state of the industry.

Fig. 1, *Annual Venture Capital Investments*, lays out the amount of money venture capital funds invest in portfolio companies each year. The chart allows us to see the run up to the tech bubble in the late 90s, which peaks at \$98.6 billion of investment in 2000 and falls to an annual investment low of \$18.8 billion in 2003. We then see the recovery through 2007, when \$29.9 billion was invested, the fall off as a result of the Great Recession beginning in 2008, and in 2009 a new post-bubble low investment amount of \$18.3 billion. For 2010 we see recovery to \$21.8 billion of investment. In the first half of 2011, \$13.8 billion was invested, a twelve percent increase from first half of 2010¹¹ and an indication of continuing recovery.

Fig. 2, *Investments by Region*, shows that the top five regions for venture capital investment, as a percentage of total funds invested in 2010, are Silicon Valley (thirty-nine percent), New England (twelve percent), Southern California (eleven percent), the New York Metropolitan area (nine percent), and the Midwest (five percent). Data for the first half of 2011 shows a similar allocation, although Southern California investment appears to have fallen off by about a percentage point and the Midwest has fallen by a half point.¹²

Whether those changes indicate real slowing or just uneven deal flow will take a few more quarters to ascertain.

Fig. 3, *Investments by Industry*, shows that the primary industries for venture capital investment in 2010 were Software (eighteen percent), Biotechnology (seventeen percent), Industrial/Energy (primarily "Clean Tech") (fifteen percent), Medical Devices/Equipment (eleven percent), and Information Technology Services (eight percent). The primary change appearing in the first half of 2011 is that Clean Tech investment has dropped under ten percent, with its loss in allocation shifting fairly evenly

Full%20Year.pdf. See also PricewaterhouseCoopers & Nat'l Venture Capital Ass'n, *MoneyTree Report: Q2 2011 Results*, PRICEWATERHOUSECOOPERS (2011), https://www.pwcmoneytree.com/MTPublic/ns/moneytree/files/source/exhibits/MoneyTree%20Q2%202011_Final.pdf. Other sources are available, such as Dow Jones VentureSource, which shows similar trends but different specific results.

¹¹ *Id.* The PricewaterhouseCoopers MoneyTree Report is comprehensively updated with each quarterly issuance as new historical data becomes available. Year-end data is taken from the Q4/Full Year 2010 Update and partial-year data is taken from the Q2 2011 Update, but those numbers may be adjusted in subsequent updates.

¹² *Id.*

to Software and Information Technology Services.¹³ The fall-off in Clean Tech was predicted by Randy Churchill, Director of Southern California Emerging Company Services at PricewaterhouseCoopers.¹⁴ Mr. Churchill's analysis is that Clean Tech will remain a strong industry area for investment, but as the sector matures and government funding becomes available for more capital intensive projects, the dollars invested would fall as money moves to smaller investments.¹⁵ That analysis is supported by rising deal flow in the sector in the first half of 2011, even as the dollars invested fell. For that six month period there were 154 Clean Tech deals, with 81 occurring in Q2, which was the highest quarterly number ever recorded for Clean Tech in the PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report.¹⁶

Fig. 4, *VC-backed IPO and M&A Activity*, provides perhaps the strongest evidence of recovery for the venture capital market. Initial Public Offerings (IPOs) from venture capital financed companies dropped from eighty-six in 2007 to six in 2008 and twelve in 2009, before recovering to seventy-two in 2010. The first quarter of 2011 saw fourteen venture-backed companies going public, the strongest first quarter number since Q1 2007.¹⁷ The second quarter IPO numbers continued strong with twenty-two deals reported.¹⁸ The law firm Fenwick & West LLP notes that forty-five venture-backed companies were in registration at the end of the first quarter,¹⁹ so 2011 may be one of the strongest IPO years since the tech bubble burst. On the merger and acquisition (M&A) side, the number of deals dropped from 380 in 2007 to 348 in 2008 and 273 in 2009, before recovering to 420 in 2010. For 2011 we see 123 deals in the first quarter and 79 in the second,²⁰ which also is on track to be a strong year relative to the past five.

These exit events are critical to venture capital investing, not only because they represent the pay-off on existing investments, but also because they represent the end of the investment cycle. Over the past several years, as exits were difficult to achieve, venture capital funds had to continue to invest cash to support companies that otherwise would be getting needed funding from new owners, or from the public stock market. With more

¹³ *Id.*

¹⁴ Interview with Randy Churchill, Director, Southern California Emerging Company Services at PricewaterhouseCoopers (Feb. 15, 2011).

¹⁵ *Id.*

¹⁶ *MoneyTree Report: Q2 2011*, *supra* note 10, at 3.

¹⁷ *See id.* *See also Trends in Terms of Venture Financings in Silicon Valley (First Quarter 2011)*, FENWICK AND WEST LLP, 2, available at http://www.fenwick.com/docstore/VCSurvey/Q111_VC_Terms_Survey_Report.pdf.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *MoneyTree Report: Q4 2010/Full-year 2010*, *supra* note 10, at 14; *MoneyTree Report: Q2 2011*, *supra* note 10.

money going (on an unplanned basis) to existing portfolio companies, there was less money available to make new investments. Thus, when pay-offs are slowed, fewer new companies get funded. The continued return of the IPO and M&A markets will clear the remaining backlog and allow venture capitalists to turn to new investment opportunities.

Fig. 5, *Annual Investment in VC Funds*, shows a steady decline in limited partner investment commitments to venture capital funds from over \$31 billion in each of 2006 and 2007 to \$26.4 billion in 2008, \$16.3 billion in 2009 and \$12.3 billion in 2010.²¹ This trend is particularly troubling when compared to the amounts venture capital funds were investing in companies over the same time periods, shown on Fig. 1, above. One commentator summed up the general view by noting, with strong understatement, “[s]ince the first quarter of 2009, venture capitalists have invested significantly more in companies . . . than new capital that has been committed to venture funds . . . which is not sustainable over a prolonged period.”²² The first half of 2011, however, showed fundraising up substantially to \$10.2 billion,²³ which still is less than the \$13.8 billion invested over that six-month period, but is a marked improvement from the \$21.8 billion to \$12.3 billion disparity in 2010. One potential distortion of the fundraising data is the recent formation of self-funded entities by the “uber-rich” who have cashed out of their venture-backed companies and seem, in growing numbers, to be creating investment organizations.²⁴

Despite the increased flow of money into venture capital, the troubling aspect of the fundraising numbers comes from the concentration of the money, with over half going to four firms: Bessemer Venture Partners, Sequoia Capital, JP Morgan and AccelPartners.²⁵ While there always will be some level of investment concentration, the number of funds garnering new investment commitments in the first half of 2011 was the lowest since the first half of 1995.²⁶ One conclusion that can be drawn from the venture capital fundraising numbers is that an industry contraction could be underway. A good number of venture capitalists would applaud a

²¹ *MoneyTree Report: Q4 2010/Full-year 2010*, *supra* note 10.

²² *Trends in Terms of Venture Financings in Silicon Valley (Third Quarter 2010)*, FENWICK AND WEST LLP, 2, available at http://www.fenwick.com/docstore/VCSurvey/Q310_VC_Terms_Survey_Report.pdf.

²³ *MoneyTree Report: Q2 2011*, *supra* note 10.

²⁴ E.g., OMIDYAR NETWORK, <http://www.omidyar.com> (last visited Oct. 28, 2010) (an investment organization established by the founder of eBay, Inc).

²⁵ *Trends in Terms of Venture Financings in Silicon Valley (First Quarter 2011)*, *supra* note 17; Press Release, Thomson Reuters and the National Venture Capital Association, Venture Capital Industry Raises \$2.7 Billion in Q2 2011 (July 11, 2011), available at <http://www.reuters.com/article/2011/07/11/idUS113680+11-Jul-2011+HUG20110711>.

²⁶ *MoneyTree Report: Q2 2011*, *supra* note 10.

contraction as it normally would suggest higher returns for the surviving funds (as less money chasing deals means better pricing for venture investors). However, not all funds serve all industries, regions or investment stages. As a result, if there is shrinkage, there is likely to be some disproportionate impact until the market adjusts to the opportunities created by the new shortages. For example, it is possible that the beginnings of this contraction have contributed to the downward shift in investment activity in Southern California and the Midwest regions, discussed above in connection with Fig. 2.

In summary, we are seeing a recovery in venture capital from the immediate impact of the Great Recession. The positive trends in IPO and M&A activity suggest that the recovery is likely to continue. The concentration of new fundraising to only a few venture capital firms could be an indication of a meaningful contraction in the venture capital industry that is likely to have its greatest impact in the regions, industries and stages of investment not served by the very large funds now attracting investment commitments. Although industry contraction is suggested by the data, the investment concentration simply could be an indication that, in that portion of the industry's recovery, the first movement is to large, high quality funds, with money flowing to smaller, lower profile funds later.

Generally speaking, with low interest rates, the gradual re-emergence of acquisition debt to support the M&A market, and a returning (and potentially robust) IPO market, the outlook for venture capital investment activity is good. The venture capital industry, as a job creation driver, is moving in the right direction.

IV. IMPACT ON TRANSACTION TERMS

From the perspective of the entrepreneur who may be seeking venture capital financing for his company, and the lawyers who represent those companies, the next question is whether all this venture capital industry upheaval has resulted in the venture funds presenting tougher investment terms to potential portfolio companies.

This is a difficult question to address for a number of reasons. First, different funds take different investment approaches. Even in the best of times, some venture capitalists invest only under terms that are significantly favorable to them as investors. Likewise, in the worst of times, some investors offer the same "vanilla" terms they always use, assuming that picking the right companies is more important than an aggressive set of legal rights. Thus, regardless of the state of the venture capital industry, an entrepreneur at any time may be presented with terms she perceives as being harsh or as even-handed.

In addition, deal terms vary markedly between the East Coast and West Coast. Venture capital investment almost always involves significant participation in and oversight of each of the portfolio companies by the venture capital professionals. As a result, simple logistics makes venture capital investment an inherently local, or at most regional, activity. Just as Australia's isolation allowed for the development of marsupials, the isolation of venture capital markets has resulted in very different norms and expectations in different parts of the country. On the East Coast, venture capital investment is more like private equity and often carries investor-favorable terms that make venture capital preferred stock look very debt-like. Redemption rights and cumulative dividends, which will be discussed below, are common on the East Coast.²⁷ On the West Coast, as we will see, those terms are rare.²⁸

Also, the data presented often has limitations. For example, the law firm Cooley LLP prepares a quarterly "Venture Financing Report."²⁹ While the publication provides a range of very useful information, the data is collected from transactions in which Cooley participated as legal counsel.³⁰ While this improves the likelihood that the data has been collected accurately, the data also is skewed by the practice standards at Cooley and the specific markets and relationships that make up that premier firm's business.³¹ Other publications seek to report on terms offered nationally. Unfortunately the disparity in terms between the East Coast and the West Coast makes this like looking at the average between a horse and a cow. The result tells you little about anything that actually exists.

The following discussion utilizes data primarily from the quarterly publication "Trends in Terms of Venture Financings in Silicon Valley" from Fenwick & West LLP.³² This law firm collects data on a large number of transactions and has been publishing its survey with information going

²⁷ See Stacey E. Curry Bishop, *NVCA Model Investment Form Documents*, 1853 PLI/CORP 43 (2010).

²⁸ I have not identified any meaningful data on how the Midwest fits into this split, although anecdotal information suggests that it may be more similar to the East Coast than the West.

²⁹ *Venture Financing Report, 2010 Year in Review*, COOLEY LLP (Aug. 19, 2011), http://www.cooley.com/files/82004_VF2010Q4.pdf.

³⁰ *Id.*

³¹ See *id.*

³² *Trends in Terms of Venture Financings in Silicon Valley*, FENWICK & WEST LLP, <http://www.fenwick.com/publications/6.12.0.asp> (last visited Aug. 17, 2011). Each report provides a rolling presentation of eight annual quarters, so assembling information going back to 2002-Q3 requires the use of a number of the reports. As they overlap in coverage (and, unlike the PricewaterhouseCoopers/National Venture Capital Association *MoneyTree Reports*, are not continuously revised) the specific reports used are not cited. At the time of this writing, 2011-Q1 was the most recent available report. Other sources are noted when their information is used.

back to 2002-Q3. The limitation is that the data comes from Silicon Valley venture capitalists and companies. While this data is indicative of the West Coast as a whole, it does not give us any insight on East Coast practices and trends. With that caveat, the following discussion focuses on trends in key venture capital transaction terms, as well as the implications of those trends.³³

Figure 6, *Price Change from Prior Rounds*, examines whether the per-share price of the stock issued by a company in a venture capital investment round represents a higher, even or lower price when compared to the price used in that company's immediately prior investment round. Figure 6 shows a trend of upward pricing changes from financing round to round in a majority of transactions that continued through 2008-Q4, but with the percentage of deals showing upward changes beginning to decline dramatically in 2008-Q2. As the impact of the Great Recession built, the direction of change shifted to more deals being down (lower priced) in 2009-Q1 and Q2. Pricing turned upward in 2009-Q2 and by 2009-Q3 a majority of investments again were in up rounds. This continues to be the case through 2011-Q1, the most recent data available. It is important to contrast the left side of this chart from the right. Coming out of the tech bubble, a majority of deals were down rounds through the end of 2003, while the Great Recession resulted in only two quarters where down rounds outnumbered upward price movement.³⁴

Round-to-round upward price change shows that the companies receiving venture capital investment are putting that money to good use and that investors continue to see their prospects as positive. When companies return to the investment trough for more money, investors perceive them as having taken, for example, a \$2 million investment and created more than \$2 million in increased enterprise value. Preferred stock is usually issued in series (Series A, Series B, and so on) so that each investment transaction can reflect the specific rights applicable to that round. Frequently (at least in the absence of untoward events) there are no significant differences between the rights of each series of preferred stock—the only differences are that each has its own per share investment price. The irony for legal professionals, of course, is that this most important deal term usually is set before the lawyers ever get involved.³⁵

Figure 7, *Liquidation Preferences*, examines three different mechanisms that may be used in setting the liquidation preference rights granted by a company to its venture capital investors. Venture capital preferred stock almost always is granted a "liquidation preference," that is, the right to receive proceeds from a merger, sale or liquidation of the

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

company before any amounts may be paid to the holders of the common stock (which is typically held by founders and employees). Since the fact that the preferred stock gets paid before the common stock is virtually always a given, the first factor we will look at on Fig. 7, *senior priority*, addresses whether the newly issued series of preferred stock has a priority versus the preferred stock already issued in earlier financing rounds. Demanding a senior priority is an indication that investor unease is triggering a desire for the right to be first through the exit door. What we see is that the historical axiom of “last money in is first money out” is becoming less and less the case. The general downward trend of the post-bubble era in senior priority deals flattened as a result of the Great Recession in 2008 and 2009, but in 2010 again began edging downward. Senior priority currently is granted in less than half of West Coast deals.³⁶

The second factor addressed in Fig. 7 is the percentage of deals having a *multiplier* applied to the investors’ liquidation priority preference. The basic liquidation priority preference amount equals the amount invested in the preferred stock (accrued but unpaid dividends, if applicable, typically are added). So, if the shares of a series of preferred stock cost \$1.23 per share to purchase, then their normal liquidation priority preference amount is \$1.23 per share. Only after the preferred stockholder gets its \$1.23 per share does anyone with a lower preference priority get any proceeds.³⁷

A multiplier says that for a particular series of preferred stock the priority preference amount is not \$1.23 but some multiple of that purchase price—perhaps 1.5 or 2 times—to be paid before the next level of priority gets anything. Thus, a multiplier builds a profit into the priority preference that is to be paid before the next lower priority holder gets anything at all. A multiplier is a strong indication of investor perception of higher-than-usual risk. As with senior priority, Fig. 7 shows a general downward trend in multipliers in the post-bubble era. That trend stopped in 2008 in reaction to the uncertainty of the Great Recession but, after peaking in 2009-Q1, again began to slide. Currently less than fifteen percent of West Coast deals use liquidation priority preference multipliers.³⁸

The third liquidation preference factor presented in Fig. 7 is a separate concept called *participation* rights. A participation right applies after all the liquidation priority rights have been satisfied (assuming there is enough merger, sale or liquidation proceeds to pay the full priority rights) and refers to the right of a series of the preferred stock to participate in the sharing out of the remaining proceeds. Absent a specific corporate charter term to the contrary, the residual ownership interest in a corporation typically is held by the common stock. If no preferred stock participation

³⁶ *Id.*³⁷ *Id.*³⁸ *Id.*

rights are granted then, after all the priority rights have been satisfied, all the remaining proceeds available are paid out to the common stockholders. A preferred stock liquidation participation right means that after a series of preferred stock has received its priority amount, and all other lower priority amounts have been satisfied, the holders of that series of preferred stock get to participate in the residual distribution to the common stockholders as though they held common stock instead of their preferred stock. Their proportionate allocation is based on the number of shares of common stock their preferred stock would convert into if it were converted. Thus, the participating preferred stockholders are sharing when the holders of the common stock are receiving their first dollar of proceeds. The holders of the participating preferred stock, having gotten back their entire investment amount (and perhaps more if they have a dividend right or a multiplier tied to their priority right), are receiving a gain while the common stockholders are getting their first dollars out.³⁹

In the absence of a participation right, a series of preferred stock gets its priority amount paid out and is finished. If the company is sold for a high price, the preferred stockholders have to decide whether they are financially better off by taking their priority amount and no more, or whether they should convert their preferred stock to common stock, forego their priority right and go through the liquidation process as a common stockholder. Having a participation right makes that problem disappear by allowing the preferred stockholder to keep the priority right and share in the distribution to the common stockholders.⁴⁰

Even before the tech bubble, my personal experience was that participation rights were very common. Figure 7 shows that in 2002 they were provided in approximately three-fourths of deals in the aftermath of the tech bubble, but that the frequency of these rights has been in steady decline since then. The decline leveled in the second half of 2007 through 2008-Q3, but participation rights now are included in less than half of West Coast deals.⁴¹

The general message of Fig. 7 is that liquidation rights in West Coast deals have gotten steadily less pro-investor over the last nine years. Of course, the available data begins at a point when investors were defensive coming off the collapse of the tech bubble, but the basic trend was not seriously disrupted by the Great Recession. While my impression is that liquidation terms have reached an equilibrium point, it is possible that they will continue to ease.⁴²

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ The percentages of deals on Fig. 7 do not add up to 100 because all, some or none of these factors may appear in the terms of any one series of preferred stock.

⁴² *Trends in Terms of Venture Financing in Silicon Valley*, *supra* note 32.

Figure 8, *Cumulative Dividends*, presents the point noted earlier that on the West Coast these rights are rarely used. A cumulative dividend in a venture capital transaction is a dividend right that is, in effect, automatically “declared” on a periodic basis, usually annually, but maybe quarterly. By declaring a dividend a company obligates itself to pay that dividend. Under typical venture capital terms, a dividend that has been declared on the preferred stock, but not yet paid, usually must be paid as part of a liquidation priority preference payment, a redemption payment, or upon conversion of the preferred stock to common stock. The alternatives to a cumulative dividend right are no dividend right (except perhaps the right to participate with the common stock on any dividend payable to it) or a dividend priority preference payable “when, as and if declared.”

Since venture capital financed companies presumably create a very high return on cash available to them, they rarely pay dividends in the ordinary course of business. Thus, any dividend rights typically are not paid until some exit event in which liquidation, redemption or conversion rights come into play. A cumulative dividend acts like an interest factor, often like compounded interest, on the venture capital preferred stock investment. Over time it can create a significant shift in value to the preferred stockholders.

Figure 8 shows that less than ten percent of West Coast deals, regardless of the economy, include cumulative dividend rights. The Cooley LLP Venture Financing Report showed that cumulative dividends appeared in thirteen percent of the deals they did in 2009-Q1.⁴³ Cooley also reports that outside of Silicon Valley (i.e., the East Coast) that it sees cumulative dividends in thirty percent to forty percent of its deals.⁴⁴ Other surveys indicate cumulative dividends in up to fifty percent.⁴⁵ As noted, East Coast venture capital preferred stock tends to have more debt-like terms that what is normally seen on the West Coast.

Figure 9, *Anti-dilution Adjustments*, shows the types of price protection required by venture capital investors. Setting the price of a preferred stock for purchase by venture capital investors is as much art as it is science. One reason is that the value of the stock is largely dependent upon future events: whether the company uses the investment to achieve its business plan objectives on time and on budget. Because of the risk that future events may demonstrate that the investors over-valued the stock, they typically require a remedy through *price anti-dilution protection*.

Dilution is the result of the corporation issuing more shares. To offer a very simple example, if a company has ten shares of common stock outstanding and you own five, you own fifty percent of the company’s

⁴³ *Venture Financing Report, 2010 Year in Review*, *supra* note 29.

⁴⁴ *Id.*

⁴⁵ See Curry Bishop, *supra* note 27.

stock. If the company issues ten more common stock shares, your shares are now five out of twenty outstanding shares, so they now represent only twenty-five percent of the company. You have been diluted. Because all share issuances are dilutive, the question is whether the dilution was harmful to you.

For example, if you paid \$1.00 per share for your five shares, and the new share issuance was at \$20.00 per share, you were not harmed. Because like shares are fungible and the new investor paid \$20.00 per share to get stock exactly like your shares, the new share issuance set the value of your shares at \$20.00 per share, up from \$1.00. You have a smaller portion of the company, but the portion you have is worth more, so you are ahead. You are entitled to no anti-dilution protection because the dilution was not harmful to you.⁴⁶

If, on the other hand, the new shares were issued at \$0.50 per share, then your \$5.00 total investment now appears to be worth \$2.50. This dilution is harmful to you because it demonstrates a loss in the economic value of your investment. That loss is made apparent by the fact that the new share issuance was at a per-share price that was lower than the price you paid for your shares.

Venture capital preferred stock price anti-dilution protection is triggered by a subsequent issuance of shares at a price lower than the per-share price that was paid by an existing holder when it purchased its preferred stock. The price protection anti-dilution mechanism is to adjust the rate at which the preferred stock converts to common stock. Upon a new share issuance at a lower issuance price, the existing preferred stock is amended so that it will convert into more shares of common stock. This is, in effect, a retroactive price change applied to the existing preferred stock.

For example, an investor owns four million shares of preferred stock that is convertible into common stock on a one-for-one basis. As a result of a later issuance of shares at a lower per share price, the investor's preferred stock receives an anti-dilution adjustment that provides for each share of the preferred stock now to convert into 1.5 shares of common stock. The investor still holds four million shares of preferred stock, but now that preferred stock is convertible into six million shares of common stock. This adjustment is meaningful even if the preferred stock is never actually converted.

Venture capital preferred stock has rights based on the number of preferred shares outstanding and the price per share paid for that stock. Liquidation and dividend priority rights, as was touched on in the earlier

⁴⁶ We are examining strictly the pricing issue and ignoring any qualitative harm created by having an additional owner, moving to a clear minority position, and so on.

discussion, as well as redemption rights (to be addressed below) all are based on the number of preferred stock shares outstanding and the price per share paid for them. In addition, venture capital preferred stock also has participation rights, which grant the right to participate in rights and benefits of the common stock, as though the preferred stock had been converted into common stock. Participation rights include sharing in common stock liquidation and dividend distributions, for example. Obviously, if the preferred stock becomes convertible into more shares of common stock, it participates at a higher level. The ultimate participation right probably is the right to vote with the common stock. As a result of the anti-dilution adjustment described in the preceding paragraph, that preferred stockholder went from having four million voting shares to six million.

There are two basic approaches to price anti-dilution protection and the alternative demanded by venture capital investors to a great extent is an indication of their concern that the price they are paying will be justified by the company's ability to use the money to increase the value of the enterprise. A *ratchet* adjustment (which refers to a "full" ratchet, as "partial" ratchets are exceedingly rare) provides the largest conversion rate adjustment right typically granted to a preferred stock investor.

Figure 9 shows that, on the West Coast, ratchet price anti-dilution protection is rarely granted. In the aftermath of the tech-bubble, ratchets were never used in more than twenty percent of deals and, over the last five years, the rate of usage consistently has stayed at ten percent of deals or less. Cooley reports similar results.⁴⁷

Looking at other information sources, one surveyor compared small samples on each coast for the one year period ended June 30, 2008 and saw ratchets in 10.7% of deals in its Bay Area sample and in 22.9% of its New York and New England sample.⁴⁸ While these numbers may not exactly reflect reality, they do support the basic premise that West Coast deals have more company-friendly terms.

The primary alternative to a ratchet is a *weighted average formula*, which almost always means a *broad-based* formula (*narrow-based* formulas exist but are rarely used). A weighted average formula generates a preferred stock conversion rate adjustment that takes into account the amount by which the per share price went down in the new, lower-priced transaction, with a larger price drop resulting in a larger adjustment for existing holders. It also takes into account the relative number of shares

⁴⁷ See *Venture Financing Report, 2010 Year in Review*, *supra* note 29.

⁴⁸ *Venture Capital Deal Terms Report*, DOW JONES 25 (2009) (citing fifty-six respondents in the Bay Area and thirty-five in New York and New England. In contrast, Fenwick & West states in its report for 2011 Q1 that its statistics are based on 122 transactions).

being issued in the new investment in relation to the total existing number of shares, with a larger transaction (which has a greater impact on existing holders) resulting in a larger adjustment. The terms “broad-based” and “narrow-based” refer to how many of the existing ownership interests are included in the formula (only outstanding shares or also include shares issuable upon the exercise of stock options and warrants, for example). A broad-based formula includes more shares in the number deemed to be outstanding immediately prior to the new issuance, and thus results in smaller adjustments than a narrow-based formula.

Despite the fact that a broad-based weighted average formula adjustment is the least favorable to venture-capital investors, it is far and away the most common price anti-dilution adjustment used. Figure 9 shows that even coming out the tech bubble, weighted average formulas were used in approximately eighty percent of West Coast deals. Since 2006 they have appeared in over ninety percent of deals. The result of the Great Recession was a one-quarter dip to only ninety-three percent. Cooley’s reports consistently show weighted average formulas in over eighty percent of deals from 2006 through 2010.⁴⁹

The final set of data tracked in Fig. 9 is the nominal percentage of deals where no price anti-dilution protection was provided. It is important to note that the deal term being addressed is only the price protection aspect of anti-dilution rights. Virtually every convertible security includes a separate right to anti-dilution protection unrelated to relative transaction pricing. This protection is triggered in the event of a structural change in the security into which the convertible security converts. For example, venture capital preferred stock typically converts into common stock. If the common stock of a company represents one million shares and the preferred stock, converting one-for-one, also represents one million shares, what should happen if the common stock is split such that each common stock share now represents four shares? With no adjustment, the preferred stock, which previously would have participation rights with the common stock on a 50/50 basis, still would be convertible into one million shares with the common stock now consisting of four million shares. The participation level is now at a 20/80 basis. The preferred stock protection against this result is a proportionate conversion rate adjustment. If the number of common stock shares has been increased by a factor of four, then the preferred stock conversion rate is also increased by a factor of four. As a result of the adjustment, in our example, there are four million shares of common stock and the adjusted conversion rate causes the one million shares of preferred stock to now be convertible into four million common stock shares, so a 50/50 participation ratio is reestablished. This right to a proportionate anti-dilution adjustment is not addressed in Fig. 9 because it

⁴⁹ See *Venture Financing Report, 2010 Year in Review*, *supra* note 29.

should appear, and absent serious error does, in every venture capital preferred stock.

The final term examined is *redemption*. In the venture capital context, redemption is the right of the investors to require the company to repurchase the preferred stock, typically at the original issuance price, plus a premium that equates to interest over the outstanding term of the investment. Redemption rights usually become available five years after the shares are issued.

For a venture capital investor, getting your investment amount back, plus a relatively low interest rate, is not a good result. Venture capital investors are looking to do far better than the six to twelve percent interest factor included in a redemption price. The fact is that redemption rights are very rarely actually exercised. In short, if the company is doing well, investors do not want to be redeemed. If the company is doing poorly, it typically does not have the resources to complete a redemption without committing a fraud on its creditors.⁵⁰ So why even grant redemption rights?

Redemption rights exist to give the investors leverage to force the company to work toward an exit transaction. The threat of using a redemption right, which would create a horrible financial strain on the company, focuses founders and management on the fact that venture capital investors want out of their investment quickly, and after five years they are getting impatient.

Figure 10, *Redemption Rights*, shows that on the West Coast, redemption rights currently appear in only about twenty percent of deals.⁵¹ Coming out of the tech bubble the rate touched forty percent, but the decided trend has been downward into the low twenties, with a small blip up in early 2008.⁵² Redemption is another area where regional differences are significant—the right is not regularly granted on the West Coast, while on the East Coast it appears in half or more of the venture capital transactions.⁵³

V. CONCLUSIONS

While the Great Recession has had a significant adverse effect on the venture capital industry, its impact on venture capital investment terms was short lived.

⁵⁰ See, e.g., DEL. CODE ANN. tit. 8, § 160(a) (2011); CAL. CORP. CODE § 500 (West 2011) *et seq.*

⁵¹ *Trends in Terms of Venture Financings in Silicon Valley*, *supra* note 32.

⁵² *Id.*

⁵³ *Venture Capital Deal Terms Report*, *supra* note 48, at 26.

In contrast to the tech bubble, in which the venture-capital industry played a major role, the Great Recession was triggered in other parts of the financial sector. Venture capital was hurt because it is dependent upon the financial markets for investment commitments (Fig. 5) and for the IPOs and M&A deals (Fig. 5) that provide its exit transactions. Yet, despite that pain, the industry appears to have moved onto a recovery path in 2011. While there is a prospect of some long-term contraction in investment in venture capital, commitments to venture-capital funds are growing and a continued significant improvement in exit opportunities for venture-backed companies may cause those commitments to grow further, staving off any meaningful industry contraction.

The most dramatic deal term movement we saw from the Great Recession was round-to-round pricing (Fig. 6), which seriously dipped in 2008. However, the valley was a sharp one, with a strong upward pricing trend beginning in 2009. Aside from pricing, we see the Great Recession causing only small movements in liquidation preferences (Fig. 7), cumulative dividends (Fig. 8), anti-dilution protection (Fig. 9) and redemption rights (Fig. 10). In fact, deal terms returned to normal trends more quickly than the overall health of the venture capital industry might have suggested.

In short, in the context of the venture capital markets, the primary impact on entrepreneurs from the Great Recession was the fall-off in the amount of venture capital investment available and lower pricing imposed on companies in their capital-raising stock issuances. Those trends began reversing in 2010 and apparently will be completely reset in 2011.

If those results continue and we see annual venture capital investments return to the \$25 to \$30 billion range in 2011, then the deal term impact of the Great Recession will have been completely extinguished. More importantly, venture capital then will return to its historic job creation levels and will play an important part in the economic recovery.